Country Commercial Guide: Panama FY-03
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CHAPTER 1. EXECUTIVE SUMMARY

COMMERCIAL OVERVIEW

Taking advantage of Panama's key location, the Government and business community have long promoted the country as an international trading, banking, and services center. Trade liberalization and privatization over the last several years have added substance to these assertions. Panama's dollar-based economy offers low inflation and zero foreign exchange risk. Panama's Government actively seeks foreign investment and there are real opportunities available in the former Canal Zone properties which were transferred to Panamanian jurisdiction in December 1999.

Due to the evolution and composition of Panama's largely services based economy, the extent and nature of local competition is limited in most non-service sectors. Although the United States is Panama's most important trading partner, with about 35% of the import market, and U.S. products enjoy a high degree of acceptance in Panama, competition from third countries is strong in several sectors including: telecommunications equipment, automobiles, heavy construction equipment, consumer electronics, computers, apparel, gifts, and novelty products.

Panama's merchandise imports decreased in 2001 by two percent over 2000 to a total of US$2.963 billion. The value of Panama's total merchandise exports in 2001 reached US$809.5 million, an increase of nine percent over the previous year.

The Colon Free Zone alone represents a larger market than Panama's entire internal market. Free Zone imports amounted to US$4.6 billion in 2001, with export of US$ 5.3 billion. These figures mark a decrease of 0.6% and an increase of 0.4% respectively in comparison to 2000, in which imports rose 11% and exports rose 6.9%. The total net contribution of the CFZ to the Panamanian trade balance (Exports-Imports) was US$718 million, up slightly from 2000**.** The prior year (1999) the CFZ experienced one of its worse years ever, a disastrous 21% decline. Zone imports are mostly luxury goods, electronic products, clothing, and other consumer products. Because of this product mix, U.S. market share is somewhat lower in the Zone than in Panama. Hong Kong is the Free Zone's biggest supplier, while Colombia and Ecuador are the two largest destinations for Zone reexports.

Panama's economy is based primarily on a well-developed services sector, accounting for about 80 percent of GDP. Services include the Panama Canal, banking, the Colon Free Zone, insurance, container ports, and flagship registry. Manufacturing, mining, utilities, and construction together account for 12 percent of GDP.

Manufacturing is principally geared to production of items such as processed foods, clothing, chemical products, and construction materials for the domestic market. The manufacturing sector developed under a sixties style import substitution high tariff regime. Panama reduced duties on manufactured items from up to 100% to a maximum of 15% in 1998. Panamanian manufacturers now face increased price competition vis-a-vis imports in many sectors.

Agriculture, forestry and fisheries make up about seven percent of GDP. Some agricultural imports are still subject to high duties with non-tariff barriers proving to be a persistent obstacle to agricultural market opening.

BUSINESS TRENDS AND OPPORTUNITIES

Consumer attitudes and many brand preferences are similar to the U.S. American television, radio programs and U.S. magazines are all available and popular in Panama. Panamanians frequently travel to the U.S. for vacation, medical treatment, study, and business. Their buying patterns and tastes are similar to ours.

U.S. products and services are well accepted and highly competitive in most product sectors. Panama boast the highest per capita GDP in the region US$3,663 (2001). Income distribution is skewed to the benefit of a relatively small, consumer goods-oriented, economically powerful class. This class enjoys a very high level of disposable income. They prefer high quality trend-setting goods where price is a secondary determinant in the purchasing decision. The majority of the population however has limited disposable income, with price and availability of credit critical to their buying patterns.

Sharply lower import duties have made U.S. products more competitive with locally manufactured items in recent years. The U.S. market share of the Panamanian market was 32% in 2001 down from 47% the preceding year. The U.S. also had 10% of the larger Free Zone market in 2000.

Panama has potential for substantial growth in the areas of electric power generation, health care services, mining exploration and operations, port services, land development, road construction, telecommunications, and tourism.

TRADE AND INVESTMENT CLIMATE

Panama has no restrictions on the outflow of capital or outward direct investment. Its accession to the World Trade Organization in mid-1997 opened up trade and lowered tariffs across the board, giving Panama the lowest average tariff rate in Latin America. The Moscoso government reversed some of these reductions by raising some agricultural goods' tariffs dramatically in late 1999 and early 2000. While the new tariff levels remained within WTO accession levels, Panama continues to obstruct agriculture imports via a slow and arbitrary procedure for issuing phytosanitary permits.

Panama’s inflexible labor laws are a source of concern for prospective investors. Firing practices are excessively regulated which reduces labor mobility and inhibits hiring. The minimum wage was recently increased to US$253 monthly (in the capital). While inexpensive in global terms, Panama's minimum wage is relatively high in a Central American context.

The privatization program in Panama has largely been concluded. It started with the sale of a state cement company and a state-owned fruit company. The Government awarded concessions for a private toll road in 1994, cellular phone service, another private toll road in early 1996, and two ports in mid-1996. Intel, the Panamanian telephone company, was partially (49%) sold in mid-1997 and is now being managed by the British firm Cable and Wireless. Cable & Wireless’s monopoly ends on January 2003 for all fixed line, long distance and international services. Government-owned casinos and race tracks were privatized in 1998. The power parastatal was restructured and converted into eight companies, which were partially sold to the private sector, in August 1998. Four American companies participated including Enron, Coastal, AES and Constellation. Two sugar mills were privatized in 1998 to local groups with some Colombian participation. Pending announced privatizations include a large convention center and the international airport. Water privatization was halted in 1998 after violent protests and appears unlikely to proceed under the current government.

Although there had been substantial new foreign investment in recent years, most of it resulting from privatization, it slowed dramatically in 2000, as opportunities and enthusiasm for further privatization dwindled. Instances of questionable government practices have soured some large international firms on doing business in Panama. These include past bidding procedures, contract obligations, project security, and a slow and imperfect judicial system.

The combination of relatively high costs for both electrical power and labor makes unit production costs higher than average for the region. Some investors complain of burdensome and excessive product registration requirements. Lack of consistent access to imported agricultural inputs due to arbitrary import procedures has also led to foreign investor complaints.

The most interesting sector for new foreign investment is in the former Canal Zone and associated military bases. Panama received a total of 364,000 acres of such territories in late 1999, including two large military bases, one of which was a major air base (Howard) that could be used as an air cargo hub or an aircraft maintenance and repair facility. The Government is actively looking for investment in the fields of tourism, marine services, ports, in-bond assembly and manufacturing. Nearly three years following the U.S. turnover, investment in these transferred properties has been limited to primarily local buyers of residential housing.

CHAPTER 2. ECONOMIC TRENDS AND OUTLOOK

MAJOR TRENDS AND OUTLOOK

The slow downturn of Panama’s economy started in 1999 and accelerated in 2002. Panama continues struggling to overcome the departure of the US military, low prices for its primary exports, higher prices for petroleum imports, reduced trade and investment due to the regional and worldwide economic slowdown, and a rapidly increasing contraction of domestic demand.

According to the Government of Panama (GOP), the economy grew 0.3% in real terms in 2001, falling from 2.7% growth in 2000. This is the lowest registered growth in a decade. Population growth exceeded general economic growth for the first time in ten years, and thus, real per capita GDP fell by 1.7%. Although Panama's 2001 nominal per capita GDP is among the highest in the region at US$3,663, this figure is unreliable as an indicator of prosperity overall, because of Panama's highly skewed income distribution. Panama's income distribution is second only to Brazil in the hemisphere in terms of inequality. The Survey of Living Standards, produced by the World Bank and the Government of Panama in 2000, estimated that 37% of all Panamanians live in poverty, including over 50% of children under age 10, and 95% of the indigenous population. In April 2002, the government announced that GDP grew 0.8% in the first quarter of the year and predicted an annual GDP increase of 1.5% to 2%. Since that report, there have been three major bankruptcies and other layoffs, as well as a report by the Industrial Producers Association (SIP) which claimed the economy was already in recession, casting doubt on that prediction.

Unemployment crept upward in 2001, rising to approximately 14.0% from 13.5% in 2000. Private economists estimate Panama's unemployment to be higher than official statistics and estimate chronic underemployment to be 25-30%.

When elected to office in 1999, President Moscoso pledged to increase social spending, slow down privatizations and protect certain areas of the agricultural sector. In following through on these promises, the government blocked the privatization of its water utility (IDAAN). The GOP is, however, in the process of modernizing IDAAN's operations and infrastructure.

In protecting politically important agricultural areas, the government raised tariffs in late-1999 to the maximum amount allowable under the WTO regime, but since then, it has lowered them on average 1-3% per year.

The government has taken some positive steps on the economic front. One of these was getting the go-ahead to use the Fiduciary Fund for Development (FFD) for debt alleviation. This was achieved through political negotiations that allowed funds originally earmarked for social spending to be diverted to debt relief. Another positive development is fiscal policy. The national dialogue also produced a law on fiscal accountability that has led to a second reduction in government spending during 2002 to keep pace with shrinking revenues and meet the legislated cap on the deficit of two percent. However, despite the spending cuts, critics point to a swelling in the government rolls, specifically a 6% increase during the first quarter of 2002, as a prime indicator that the government payroll is still too big and prone to uncontrollable fits of growth, and that the reductions are coming out of investment funds rather than current spending.

The government must resolve numerous issues in order to improve Panama's investment climate and stimulate economic growth. First, despite repeated calls from the private sector, the GOP has made no steps toward labor code reform. Second, the GOP has postponed any meaningful social security reform. Third, the GOP must develop the balance of the 364,000 acres of land and roughly 4,800 buildings that were transferred by the U.S. The Interoceanic Regional Authority (ARI), which is responsible for the development and promotion of these areas, has been incapable of attracting significant new investment to make up for the loss of jobs and income resulting from the US Military's departure. Fourth, Panama's tax code provides a meager and inefficient income stream. The government has floated proposals to reform the tax system, but with pressure from business, labor, and the political opposition, the government has yet to make any significant progress. As a result, the GOP allowed its IMF Stand-By loan commitments to expire, albeit a symbolic gesture since the GOP never drew on any IMF funds. Fifth, the government has treated existing foreign investments inconsistently, has responded slowly or not at all to changing needs in many cases and has thereby discouraged current investors and prospective new investors from committing more resources to Panama.

Despite these challenges, some sectors of Panama's economy have done well. The strong services sector can expect to post solid growth in the near future, especially the maritime and financial service industries. Other indicators, such as investment in telecommunications, several new tourism projects, the maritime and port sectors, and non-traditional agricultural and fisheries exports seem to be growing at an encouraging rate.

The sectors of Panama's economy that have suffered in the last year are traditional agriculture, manufacturing and construction, retail sales, and the exports sector (the Colon Free Zone in particular). There have been three major bankruptcies that transcend any single sector but have the potential to further undermine confidence and damage the banking industry.

STRUCTURE OF ECONOMY/PRINCIPAL GROWTH SECTORS

Panama's economy is based primarily on a well-developed services sector that accounts for over three-quarters of GDP. Services include the Panama Canal, container port activities, flagship registry, legal services, banking, insurance, and the Colon Free Trade Zone. Retailing has been in a serious slump since mid-2000. Manufacturing and construction together account for about one-fifth of GDP. Manufacturing is principally geared to production of processed foods, some apparel, chemicals, and construction materials for the domestic market. Mining accounts for less than 0.5%, while agriculture, forestry, and fisheries make up only about one-twelfth (6-7%) of GDP, yet provide employment for 15% to 20% of the population. Primary products, some of which are exported, include bananas, shrimp, sugar, coffee, meat, dairy products, tropical fruits, rice, and corn. The sectors of the Panamanian economy with the greatest potential for growth in the medium term are ports, maritime services, telecommunications, tourism, energy and non-traditional agricultural exports.

Agriculture, fisheries, and mining

Consistent with a slowing national economy, Panama's agriculture sector fell by 3.3% in 2001. The hardest hit sectors were coffee, bananas, and sugar, whose exports decreased by 30.7%, 17%, and 6%, respectively. All three exports decreased due to falling international prices. Banana exports fell even though the U.S. and its Latin American partners negotiated a WTO-compatible banana import regime that took effect in early 2001. Productivity on banana farms is low in comparison to their regional competitors and absent a radically new working relationship between banana companies and militant unions, outlook for the industry is grim.

The sectors that experienced the highest growth rates were fisheries (21.4%), cattle (21.6%) and melons (35.5%). Fisheries rebounded thanks to an 18% increase in shrimp exports, which recovered from the effects of the debilitating "White-Spot" virus that caused losses of up to 90% in 1999. Cattle production increased due to the expansion of markets in Mexico and Nicaragua and because of the success of the USG based program to eradicate the screwworm. Non-traditional fruits like melons grew thanks to US$20 million in new investments and increased export opportunities. Traditional commodities like rice and corn grew only 0.5% and 2% respectively. Rapidly increasing shortfalls in domestic production to meet demand are being forecast, particularly for rice and pork.

Although Panama paved the way for tuna exports by signing the International Dolphin Conservation Program Agreement in 1998, the country's tuna export industry remains small with potential to grow.

Production in the mining sector in 2001 dropped 12.8% for the second straight year to US$15.7 million, as low world market prices discouraged exploration for gold, silver, copper, and manganese, all of which exist in Panama. Two world-class copper mines and one gold mine are poised to begin extraction operations when prices recover. Mining investment in Panama is encouraged by a 1988 mining law that provides incentives to investors, but whose impact to date has been lackluster. Indeed, mining sector growth has been limited in the past by excessive bureaucracy in authorizing exploration, opposition by local authorities and indigenous groups, slow implementation of a mining master plan, and low world commodity prices. However, in June 2002, the GOP announced the formation of a broad coalition of interest group representatives to develop a proposal to reform the legal framework of the mining industry.

Manufacturing and construction

Industrial activity decreased 5.7% in 2001, in addition to the 1.5% decline in 2000. Industry sources are now forecasting a much larger decline in 2002. The decline is likely due to the virtual elimination of tariff protection by the former Perez Balladares administration, which was in office from 1994 to 1999. Panama has relatively high labor and electricity costs, exacerbating its competitive challenges, and the near total neglect of new product opportunities and niche markets, except in furniture and wood products.

Construction activity fell 9.7% in 2001, following increases of 7.5% in 2000 and 16% in 1999, and is expected to fall further in 2002 despite some new government projects, including the second major bridge over the canal. The decrease is likely due to the slowing economy, the completion of several large-scale projects, and the small internal market. Panama only recently signed a free trade agreement with one of its Central American neighbors that should help the construction sector. Recently finished projects include the widening of a section of the Inter-American Highway, a new road in northwestern Panama to the fast growing province of Bocas del Toro, the expansion of the Manzanillo International Terminal (the region's largest container port facility, which is owned and operated by U.S. company Stevedoring Services of America), and development of the Balboa port by Hutchinson Port Holdings (Hong Kong). Other large projects included commercial shopping centers in Panama City, modernization and/or construction of water purification plants, and the rehabilitation of the Panama Canal Railway. These projects fueled demand for cement, steel rebar, concrete block, asphalt and related products.

Banking and finance

Panama's innovative banking sector remains at the forefront of modernization and globalization. It is one of the main pillars of the economy, employing some 10,000 people and continues to attract new entrants to the market. In June 1998, Panama's banking sector came under new legislation that provides for a strong, well-financed Superintendent. Other features of the law include: Basel Accord standards for capital adequacy, enhanced authority to intervene and close banks, tougher standards to account for troubled loans, and limits on lending to related parties. Panama's banking sector has also been at the forefront of efforts to combat the inroads of money laundering and other international criminal activity.

The banking sector has remained relatively stable despite the global recession with net profits rising by 1.9% to US$486 million in 2001. Total bank assets of Panama's 77 licensed banking institutions decreased 5% to US$35.9 billion in March 2002 from the same period in 2001. Consumer and commercial lending, particularly in the automobile market and the Colon Free Zone, were key factors driving fast credit growth in 1998 and 1999. The credit splurge tapered off during 2000, as defaults on automobile loans and by retailers caused banks to adopt a more cautious approach to new lending. The trend has continued into 2002, as lending to businesses and individuals remains weak.

Retailing

Panama's retail sector has been in a serious slump for over two years, especially in the durable goods category. The slowdown in bank lending that began in early 2000 and the reduction in consumer demand that resulted from rising unemployment have hurt sales of automobiles and furniture. Several small retailers and three large firms have gone bankrupt in the last year.

Panama Canal

The Panama Canal Authority (ACP) is the Panamanian government agency that took over the duties of the Panama Canal Commission (PCC) when the Canal transferred to Panamanian control on December 31, 1999. In 2001, oceangoing commercial transits through the Panama Canal decreased by 3.6% to 13,282, while total toll revenue fell 1.4% to US$573 million. In 2001, net tonnage of transits fell 2.8% to 190 million tons. The fall in canal transits and receipts is partly due to the slowdown in the world economy. A proposed scheduled to take effect in October 2002 that will increase average transit tolls, in addition to increased service fees, should improve the profitability of the canal in the future and may pave the way for decision-making in 2004 or 2005 about the financing and construction of a third set of locks starting in 2007-2015.

The widening of the Gaillard Cut was finished a year ahead of schedule in 2001 and will permit two-way traffic of Panamax vessels by the end of this year. According to the ACP, the widening will increase Canal capacity by 20%. Design work has begun on a third set of "Post Panamax" locks and the addition of a new bridge. Canal management is also studying the possibility of projects to improve access to the Pacific entrance and provide sufficient fresh water reserves to operate the Canal well into the foreseeable future.

Colon free trade zone

The Colon Free Zone (CFZ) is the largest of its kind in Latin America and worldwide is second only to Hong Kong. In 2001, total CFZ imports fell 0.6% to US$4.6 billion, while total exports rose to $5.3 billion, up 1.4%. Levels have still not recovered from 1999, when imports fell 23% and exports dropped 17%. The CFZ's net exports in 2001 rose marginally to US$718 million. The decrease in exports was caused mainly by slowing demand from the CFZ's customers in South America, particularly Colombia, Ecuador, and Venezuela.

Tourism

The number of visitors to Panama in 2001 increased by 5.9% to 519,000. Tourist expenditures were also up, with an increase of 8.0% in 2001. Much of these increases came from several cruise lines that began disembarking in Panama and hotel startups outside Panama City. Hotel occupancy inside Panama City fell substantially because of the regional economic slowdown, the effects of September 11th and overly optimistic increases in capacity. However, they began to recover in the first quarter of 2002.

In 1994, the National Assembly passed a law granting incentives to investors in the tourism sector (primarily tax and tariff exemptions and long leaseholds), although investors have complained that overly bureaucratic application and approval processes have benefited only a few resorts. The government has high hopes for eco-tourism, but promotion budgets have been meager.

Overall, Panama has enjoyed a decade of moderate growth in the tourism sector, and should see faster growth in the years ahead. The government has put aside US$10 million for a public relations and advertising campaign, but due to red tape and a slow process to sign with an agency, the funds have been utilized very slowly. Although a lack of infrastructure, promotion know-how, and trained personnel hamper tourism development, future infrastructure projects should help boost future revenue moderately.

New restaurants, cruise port terminal and duty free shops at the former Fort Amador are one success story.

GOVERNMENT ROLE IN THE ECONOMY

From 1968 until 1989, Panama was governed by a military regime that took a statist approach to economic development. While price controls were applied to many goods, government involvement was generally less pervasive than that in other countries that pursued import substitution policies. In 1990, under the democratically elected Endara government, Panama embarked on a policy reform program to modernize government operations. Political opposition from entrenched special interest groups, however, diluted the substance of reforms.

An even more ambitious program of reforms was begun under the Perez Balladares administration that took office in September 1994. This administration passed reforms in banking, labor regulation, the tax code, and fiscal management (funding a near bankrupt government pension program). The Government also negotiated WTO accession, re-negotiated Panama's US$3.5 billion foreign commercial bank debt, privatized state-owned enterprises, and lowered tariff protection to the lowest average rate in Latin America. However, the Perez Balladares administration reversed course on prudent spending as its term ended and launched ambitious activities that increased public debt to troublesome levels.

The Moscoso government has shifted its policy focus away from liberalization and toward poverty alleviation and increased social spending. The government increased agriculture tariffs dramatically on several agricultural goods, and put off the privatization of the country's water and sewage utility and its international airport. Under pressure from farm groups, Moscoso's government has periodically used non-tariff measures to impede imports of some agricultural products arbitrarily. Opportunists in the legislature have occasionally succeeded in passing laws that run contrary to economic liberalization, including one controlling drug prices and another abolishing incentives to import new materials for processing in Panama. In 2000, under pressure from union organizations, the government decided to raise Panama's minimum wage by 12% and promised to raise it by a total of 40% before its term ends in 2004. The minimum wage debate is once again the subject of review and political discussion in mid 2002.

In early 2001, facing a worsening economic downturn, the government reached out across society to participate with business, labor, and social leaders to suggest steps to reactivate Panama's economy through a series of national dialogues. The proposals, announced in March 2001, generally called for the government to streamline its bureaucracy and speed up execution of public works. The implementation of many of the proposals has been slow and spotty. A major breakthrough in the dialogue occurred when negotiations reached agreement to allow some funds from the Fiduciary Fund to be used to pay down debt and to set a cap on government deficits.

The government regulates the activities and pricing of private telecommunications and energy suppliers. Banks and other financial service providers are regulated by a variety of bodies to ensure solvency and protection of the public's interest. The entity set up to protect consumers, prevent monopolistic practices, and defend against unfair trade (CLICAC) has generally managed cases impartially and worked according to plan.

The use of the U.S. dollar as Panama's currency means that fiscal policy is the government's principal macro-economic policy instrument. Because Panama does not issue its own currency, government spending and investment are strictly bound by tax and non-tax revenues and the government's ability to borrow.

BALANCE OF PAYMENTS

Panama's goods and services export earnings have traditionally been among the largest in the region relative to GDP. This is because the country has profited from its geographical location and dollar-based economy to develop a strong services sector. Net services surpluses and foreign direct and financial investments have traditionally financed large merchandise trade deficits.

Services: Service exports in 2001 were up 2.6% to US$539.7 million. While port activity and tourist expenditures were up, the regional economic downturn dampened demand for other Panamanian services, most notably in the canal and financial sectors.

Merchandise: Panama's merchandise imports totaled US$2.9 billion in 2001, down 13% from 2000. Panama's total merchandise exports, on the other hand, increased by 5% to US$809 million in 2001. Separately, the Colon Free Zone contributed more than US$700 million in 2001 to Panama's trade balance.

Debt: From 2000 to 2001, Panama's external public debt increased 11.8% to US$6.26 billion while total debt increased 8.6% to US$8.4 billion. Foreign official creditors hold 23% of the debt, while the private sector holds 77%, almost exclusively in the form of Brady Bonds and Eurobonds. After nearly a decade, Panama returned to international capital markets in 2000, borrowing US$750 million, partly to refinance large principal payments due in 2002. Moody's Investors Service and Fitch Ibca Duff & Phelps rate Panama sovereign debt Ba1 and BB+, respectively. Both ratings are just below investment grade and are among the highest among developing country debt. Standard and Poor's recently lowered Panama to a BB long-term credit rating, which is two steps away from investment grade. This downgrade occurred before the compromise on the Fiduciary Fund, leaving open the prospects for a return to the higher rating. Standard and Poor's justified their actions due to the prospects of increasing fiscal deficits and the continuing legislative deadlock, particularly over fiscal reforms. Increasing reports of economic difficulty led to increasing speculation in mid 2002 about possible further downgrading of Panama's rating. However, Panama's debt generally trades with less volatility and a lower risk premium than most other Latin American issues.